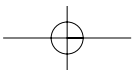
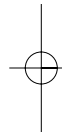
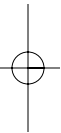


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# PART I

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## Introduction



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# 1 The Management of International Business

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## Chapter Vignette

### Introduction

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This chapter proposes that we are in the midst of a transition period in which economic competition and international business are the new arenas for international rivalry. International business is the instrument, multinational companies (MNCs) are the force, and international managers are the strategists with which nations attempt to gain a competitive advantage. In such an environment, it is vital for us to understand and learn how to manage international business. Eleven major factors underline the importance of international business and the management of such an operation. These factors are discussed in detail.

To study international management, we need to know what international business is. Therefore, we will briefly describe various forms of international business operations. These operations range from the simple import/export activities to the most challenging foreign direct investment (FDI). The first step in learning how to manage international business is to understand why firms internationalize. We will discuss theories of international expansion to illuminate this issue. The chapter argues that international management is similar to management of domestic operations, because both are concerned with achieving organizational objectives through the proper utilization of organizational resources. International and domestic management differ in managerial mentality, the complexity of the business-host government relationship, culture, and environment. A short discussion of these issues concludes the chapter.

## Chapter Vignette

### Wine War

France is well-known not only for its rich culture and architecture but also for its wine. Traditionally, French wines used to be the first choice of many connoisseurs of fine wines, and the French were very proud of this distinction. This proud tradition is under siege. The French wine industry is facing a problem that is brought about by globalization and is thus losing its allure and profitability. A dramatic blind wine tasting in 1976 in Paris did not help either. That event was attended by France's elite wine experts. Much to France's horror and America's delight, two California wines scored top honors. The shocking result transformed the wine industry worldwide. The problem, of course, is not limited to France, but France is more seriously affected by it than other countries. Family-owned vineyards are struggling to survive. Some countries, such as Australia and the United States (mostly

the state of California), are spending millions to create brands recognized around the world. The majority of wine consumers prefer the fruity flavors offered by producers in California, Australia, and Chile rather than wait for fine Bordeaux wines to mature. These new vintners are concentrated in the markets where wine consumption is growing steadily. "We are in the front lines in the fight against Australian and American wines," says Thierry Berthelot, commercial director of the Quinsac Wine Cooperative.

In recent years, a series of takeovers and mergers have created new multinationals. For instance, Australia's beer baron, the Melbourne-based Foster's Group, bought America's Napa Valley-based Beringer Blass Wine Estates. Another Australian winemaker, Southcorp, took over the family-owned premium winemaker Rosemount. "We've converted from being a cottage industry into a competitive consumer luxury-goods industry," says the chairman of Robert Mondavi Corporation, one of the world's largest winemakers.

Today, of the 10 largest wine companies, only one is French. French wine companies no longer have a dominant share in other markets. For example, three Australian companies are dominating 80% of their home market. French wine producers are reluctant to consolidate, modernize, and standardize a recipe for efficiency. Bordeaux by itself possesses 20,000 different producers. "We stick to our own home regime just when we must begin to compete in a universe of consumers who dress in Nikes, eat Big Macs, and drink Coca-Cola," expresses Jacques Berthomeau, a critic of the French wine industry, who has published a report by the French Agriculture Ministry highlighting their problems. The new wine producers enjoy many advantages over France, including new facilities and the use of modern management techniques. Another advantage for Australian, American, and Chilean winemakers is that these countries work in steady, hot climates that produce regular harvests and consistent wines, while the Bordeaux and Burgundy producers have to deal with unpredictable weather.

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## Introduction

From the end of World War II until recently, many countries, and particularly the United States, were preoccupied with the threat of communism and the danger of another world war. The United States served as a great security force against communism and provided the much needed stability for world trade to flourish. From 1950 to 1972, world trade increased at an average of 5.9% per year after adjusting for inflation.<sup>4</sup> In the last quarter of the past century, world exports grew almost seven times.<sup>5</sup> Of course, new technologies, falling transportation costs, improvements in education, and increased opportunities for international business contributed to economic growth. Without political stability, however, world trade could not have flourished at a steady and healthy rate. During this period, the United States acted as the police force of the world, and it was preoccupied with the task of containing communism. To maintain this political stability, the United States spent a relatively large amount on defense. The actions of the United States allowed the world, excluding the communist countries, to enjoy economic development at rates that were higher and persisted longer than in any previous period in history.<sup>4</sup>

While the attention of the United States was focused on fighting communism, other nations were able to devote comparatively more time and capital to developing their economies. Under the security umbrella provided by the United States, and the resulting stability, nations engaged in international trade and export. At a time when other countries, such as Japan, were expanding their markets globally, the United States was busy fighting communism. The commitment of the United States to heavy military expenditure was freeing resources and providing opportunities to other nations, particularly Western Europe and Japan, to directly challenge the U.S. share of the world market.

In military affairs and politics, except for the communists, other countries acquiesced to U.S. leadership. Economically, however, they found much more room and opportunity to contest U.S. leadership, and they often assumed a prominent position. In the past, military might would often secure economic domination and wealth for the superior nation. In this period, the fruits of U.S. military power, however, accrued to other nations too. The relatively safe and secure environment following World War II allowed world trade to expand. Increased world trade produced a higher degree of interdependence among nations. Economic interdependencies and the unacceptable consequences of a nuclear war produced a new mentality. For the first time, many nations began de-emphasizing brute force as an acceptable means of conflict resolution. The buildup of the most powerful military force in human history was making military domination less appealing to other countries. Economic competition and international business become the arenas for future rivalry.

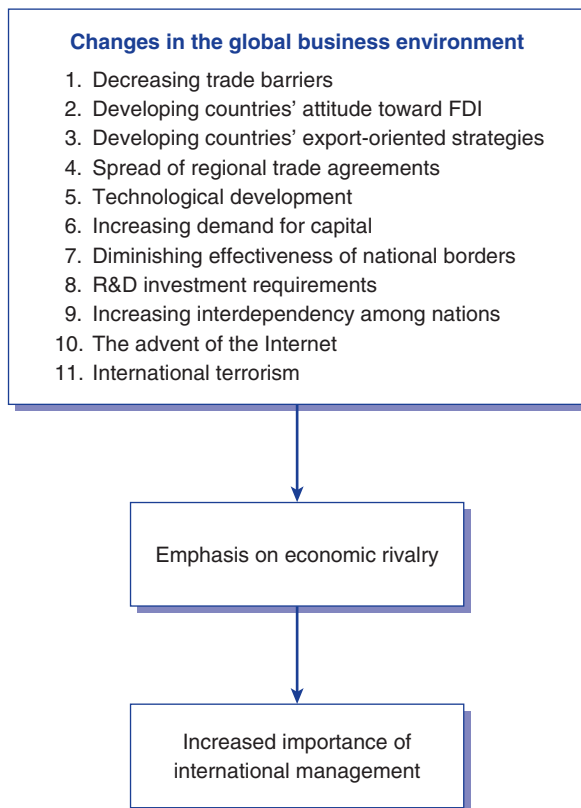
The world is still going through some fundamental changes. The threat of a major military confrontation among the world superpowers is diminishing. The conditions that forced the United States to seek military supremacy are gradually disappearing. The former adversaries are seeking help from each other, and old friends are now posing as serious competitive challengers. In short, political and military rivalries are losing ground to economic competition among countries. Global markets and international business are becoming the new battlegrounds. Some governments, for example, spend heavily to support their industries and help them achieve global competitive positions.

Faced with the reality of losing markets to these countries, some are debating the need for a U.S. industrial policy to help secure current market share and to regain lost market shares. They point out the close relationships between government and industry in Japan, China, and other countries that have promoted the expansion of their industries globally. This debate brings into sharp focus the importance of international business. We may question whether the United States needs the type of industrial policy used by other countries, but we certainly need to understand international business and how to manage it. The complexity of international business and the difficulty of managing it were reflected in the French winemakers' problems presented in the vignette at the beginning of this chapter.

Gaining a competitive advantage in the global market is possible only if we understand the underlying forces and concepts of international management. The application of these concepts in managing the cultural and operational diversity of international business is a challenging task.

## The Changing Profile of the Global Business Environment

There are many factors that increase the impact of international business, and consequently the role of MNCs, in our lives. The increased volume of international business heightens the importance of international management. The world economy is moving ever faster to a highly interrelated, interdependent state, in which no nation will be immune from the forces of the global market. In such an environment, it is vitally important that we know how to manage international business operations. Eleven major factors underline the significance of international business (see Figure 1.1).



**Figure 1.1** The Changing Profile of Global Business

## Decreased Trade Barriers

The tendency of most countries is to strive for free world trade and the removal of trade barriers. A very good indication of this tendency is the expansion of world trade. During the last quarter of the past century, world trade expanded more than 19 times (see Table 1.1).

The supporters of free trade believe that free world trade is vital to their economic prosperity. Since World War II, countries that have been more open to international business and free trade have grown faster than countries that were less open to the global economy (p. 233).<sup>8</sup> Some, however, would like to take advantage of the open markets of other countries without reciprocating and allowing others free access to their domestic markets. A few have been fairly successful in such practices. The imposition of trade and nontrade restrictions has created friction among the European countries, Japan, and the United States. The handling of such friction, however, suggests the willingness of all to solve these problems in a mutually acceptable and amicable manner. Of course, totally free world trade will not arrive overnight. But there is an inexorable movement toward the removal of most trade restrictions and barriers.

Certain transitory arrangements are already developing. For example, Europe has created an integrated economic and monetary system. An integrated Europe could produce a market larger than the United States. The United States, Canada, and Mexico have created the North America Free Trade Agreement (NAFTA), which removes most of the trade restrictions

**Table 1.1 World Trade Trends: 1970 to 2000**

<b>Year</b>	<b>1970</b>	<b>1980</b>	<b>1990</b>	<b>2000</b>
<b>Exports (FOB), billions of U.S. dollars</b>				
World	298.8	1,945.9	3,438.6	6,310.1
Industrialized countries	223.0	1,265.1	2,454.1	3,984.7
Developing countries	75.8	680.8	984.6	2,325.4
United States	42.7	225.6	393.6	781.1
<b>Imports (CIF), millions of U.S. dollars</b>				
World	313.5	2,015.6	3,532.2	6,512.8
Industrialized countries	232.4	1,400.4	2,573.3	4,317.0
Developing countries	81.1	615.3	956.9	2,195.8
United States	42.4	257.0	517.0	1,257.6

SOURCE: References 6, pp. 128–135; 7, pp. 130–141.

NOTE: The data prior to 1995 exclude Eastern Europe and the former USSR. FOB, freight on board; CIF, cost, insurance, and freight.



among them and creates the largest free trade bloc. A free trade agreement between the United States and the Central American countries (CAFTA) was signed. Members of CAFTA are the United States, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua. Similar events may occur in the Australasian region.

### Developing Countries' Attitude Change

The attitudes of many developing countries toward MNCs and FDI have changed. Before the mid-1970s, most developing countries took a dim view of FDI. Expropriation, the forced divestment of foreign assets, and nationalization, the host government seizure of MNC assets, were frequently used as a policy choice by many developing countries in their disputes with MNCs. The large number of pre-1970s expropriations has been attributed to certain problems that developing countries were experiencing. Among them were the lack of administrative capability, the low level of economic development, and an inability to service foreign debts.<sup>9</sup> Also, the East-West conflict was fueling the flames of disputes between the MNCs and the developing countries. After the mid-1970s, however, there has been a dramatic decline in the number of expropriations and nationalizations. This was due to two factors: (1) the improved capabilities of developing countries as discussed below and (2) the realization that a significant relationship exists between FDI and economic growth.<sup>10</sup>

As developing countries improved their economic and political capabilities, the need for ownership control through expropriation and nationalization diminished. Now they can achieve their objectives through taxation and performance requirements rather than by direct control. The changing attitudes of developing countries toward FDI have led some to argue that the attractiveness of foreign investment is growing and its supply is decreasing. Consequently, competition to attract FDI should escalate, and governments may outbid each other with packages of investment incentives and inducements.<sup>11</sup> This may result in increased international trade and may open up previously inaccessible markets.

### Adoption of Export-Oriented Strategies by Developing Countries

Hoping to duplicate the success achieved by Japan, Korea, and other Asian nations, many developing countries are adopting an export-oriented strategy of economic growth. The circumstances under which Japan, and to some extent Korea, employed their export-oriented strategies have changed. During the period in which these countries used export-oriented strategies,

the U.S. market absorbed the bulk of their exports. This resulted in a substantial trade deficit in the United States. Since this trend cannot continue unabated, and the United States is determined to reverse it, other nations may not fully succeed in emulating Japan. If these countries do not succeed in keeping their markets relatively closed to others, global exports will increase, international trade will expand further, and international management will gain more prominence.

Export-oriented strategy, in part, involves MNCs' participation. As Lecraw and Morrison<sup>12</sup> have noted, 30% to 40% of industrialized countries' imports are through intrafirm trade by MNCs. As more countries view MNCs as an instrument for achieving this goal, we must understand how these firms operate and how they are managed.

### Spread of Regional Trade Agreements

Regional trade agreements and pacts are reducing trade restrictions among the members and increasing intraregion trade. Membership in regional trade agreements is on the rise.<sup>13</sup> The most notable trade agreements are NAFTA, the European Union (EU), the Association of South East Asian Nations (ASEAN), and the Andean Pact.

Some speculate that in the future there will be three trading blocks dominating world trade. The first bloc is the EU. The second bloc is the ASEAN, with the expanded membership that could include Australia, India, and Japan. The third bloc is America, with the membership of Argentina, Brazil, Canada, Chile, Mexico, the United States, and Venezuela. There could be relatively free or open trade within these blocs and trade restrictions between them.<sup>3</sup> A strategic response to such a scenario is for firms to have a foothold within each bloc or form strategic alliances with those that already operate within the blocs. Either case results in the expansion of the roles and scope of international management.

### Technological Developments

Recent technological developments, particularly in manufacturing, have altered the nature of international business. Robotics, computer-aided design (CAD), computer-aided manufacturing (CAM), and flexible manufacturing have reduced production costs for most products. These technologies have also reduced the labor component of some products. As a result, the low-labor-cost position is less effective as a competitive strategy. Therefore, we expect that the low-labor-cost countries will try to tap MNCs for technology transfer and attempt to move up the supply chain.

## Global Demand for Capital

One of the key features of globalization is the increase in capital mobility, which propels national and local governments alike into a heightened competition.<sup>14</sup> Competition for capital will increase further as demand for it rises. Demand for capital from Eastern European countries, and also from the various republics of the former Soviet Union, will likely intensify competition in capital markets. Another important factor in the rising demand for capital is the sovereign debt crisis of the 1980s. In the 1980s, heavily indebted developing countries experienced great difficulty paying back their debts. This resulted in a very serious financial strain on the American and European banks and financial institutions that had given them the loans. Ever since, these institutions have become more cautious, and private sources of capital have become scarce and costly. The financial turmoil during the 1990s in Southeast Asia did not improve matters either. Consequently, more countries are viewing the equity capital from MNCs as a viable alternative. They are realizing the important role of FDI in economic development<sup>15</sup> and its impact on future opportunities for catching up with the developed countries.<sup>16</sup> This is another reason for the changing attitudes of developing countries toward MNCs.

## Diminishing Effectiveness of National Borders

Slowly but steadily, national borders are losing their effectiveness in dealing with MNCs. Although we are witnessing a rising national fervor among the subjugated people of the former Soviet bloc, there is evidence that certain new developments are evolving that defy the traditional model. For example, a number of Americans with dual citizenship have served in the governments of Armenia, the former Yugoslavia, and Estonia. In 1998, a U.S. citizen, Vadas Adamkus, was elected president of his native Lithuania. The number of countries that allow dual citizenship is on the rise. Every year, more U.S. citizens claim a second nationality. Overall, the requirement for gaining dual citizenship in these countries is for one to have been born there or have a parent or grandparent as a citizen of those countries. On that basis, and based on the U.S. Census data, it is estimated that at least 500,000 people in the United States are eligible for dual citizenship. This trend has spawned a burgeoning area of study that draws from such diverse disciplines as law, sociology, anthropology, and philosophy. These scholars call the new way of living “flexible citizenship” or “transnationalism.” According to them, the old model of nationality is outmoded in this globalizing world.<sup>17</sup>

The top executives of some well-known American firms are foreign citizens. The number of foreign executives in American and European corporations

is on the rise. Even staid Japanese firms have not been immune to this trend. After Renault, the French automobile company, took over Japanese carmaker Nissan, it dispatched a Brazilian-born executive as its first foreign chief operating officer.<sup>18</sup> Also, Sony, for the first time, selected Howard Stringer, an American, as its chairman and chief executive officer.<sup>19</sup> For many years, European firms have been preparing for a borderless market in which the nationalities of managers have no bearing on their selection and cross-national career advancement is a norm. Many well-known European firms regularly promote foreigners to their top executive ranks.

The international agreement that created the World Trade Organization (WTO) and empowered it with enforcement authority is a clear indication that, slowly but inexorably, borders are vanishing. It should be noted that for the first time, governments may face the situation where their sovereignty could be curtailed by WTO rules. As the critics of the WTO argue, "The WTO is basically the first constitution (with a global reach) based on the rules of trade and the rule of commerce. Every other constitution has been based on the sovereignty of people and countries" (as quoted by the Indian activist Vandana Shiva in Ref. 20, p. 125). This indicates that trade has assumed a prominent position in our international perspective. Such a view, and the fact that some of the governments' sovereign powers could be challenged by WTO rules, suggests that in the future, nations may face the diminishing effectiveness of national borders and loss of sovereignty.

### Investment Requirements of New Technologies

The enormous investment required in new technologies and in research and development and the increasing scale of economies needed for an optimum operation are compelling firms to consider the whole world as a market. In many industries, even the largest and most resourceful firms cannot afford the enormous investment required in today's research and development and new technologies. For example, the estimated U.S.\$1 billion needed to develop a new generation of dynamic random access memory chips (DRAMs) forced IBM to form a joint venture with Toshiba Corporation of Japan and Siemens AG of Germany.<sup>21</sup> Similarly, because of the huge cost of developing new drugs, giant pharmaceutical companies such as Glaxo Wellcome, Smith Kline Beecham, and American Home Products are forced to look for merger partners.<sup>22</sup> The immense operations and marketing costs of new high-technology products, along with other requirements, have been the driving force behind the increased internationalization and cross-border corporate mergers. Even the U.S. defense industry has been forced to adjust due to the skyrocketing costs of new technologies. Recently, for example, a number of European countries were invited to join in producing the radar-evading Joint Strike Fighter jet. The Joint Strike Fighter project spans more than two decades, is considered the biggest military

project in history, and could cost U.S.\$200 billion. The interesting aspect of this deal is that not only have other nations accepted involving the U.S. defense contractors in their military operations, but the United States has also invited the other countries to participate in a U.S. military project.<sup>23</sup>

### Increasing Interdependence Among Nations

International linkages among countries are creating a higher degree of interdependency, characterized by the increasing volume of FDI. Tables 1.1 and 1.2 illustrate the increase in FDI during the 1970 to 2000 period. While U.S. FDI has been increasing, other countries' investment in the United States has been on the rise also. From 1970 to 2000, U.S. FDI increased more than 15 times. In contrast, FDI in the United States expanded more than 93 times. By 2000, U.S. investment abroad was only slightly larger than FDI in the United States.

In three phases, international linkages have been growing since World War II:

1. The first phase began with the successive reduction of international trade restrictions, which increased world trade. In the mid-1980s, trade was 33% of the gross domestic product of developing countries. It rose to 43% in the mid-1990s.<sup>24</sup> The WTO estimates that due to trade liberalization, real-world income could increase by U.S.\$510 billion annually.<sup>25</sup>
2. In the second phase, interdependency through trade was followed by financial integration, which was aided by recycling of the Organization of Petroleum Exporting Countries' surplus during the 1970s. The revenue generated by rising oil prices created a huge surplus, which was invested in Western economies. For such an immense amount of money, the Western economies were the best and safest places for investment. This increased interdependence further.

**Table 1.2** The U.S. Direct Investment Position Abroad and the Foreign Direct Investment Position in the United States, 1970 to 2000  
(in Millions of U.S. Dollars)

Year	1970	1980	1990	2000
Total U.S.	78,178	215,578	424,086	1,244,654
All countries	13,270	68,351	396,702	1,238,627

SOURCE: Reference 4.

3. Now we are experiencing the third phase of international linkage, which is often referred to as globalization. Globalization is the integration, across borders, of markets for capital, goods, services, knowledge, and labor.<sup>26</sup> The characteristics of this phase include FDIs made by MNCs and technological alliances among them.

A large and growing portion of world trade involves intrafirm trade. For example, in the case of the United States and Japan, more than half the total trade flow is related to intrafirm transactions.<sup>27</sup> These are signs of changing times and the globalization of business. The introduction of market forces, freer trade, and widespread deregulation is happening all over the world. It is signaling that, more than ever before, international trade and investment play an eminent role in our lives. Products are produced everywhere and sold and consumed everywhere. It is becoming very difficult, if not impossible, to identify the national origin of many products. Today, products are assembled from parts produced all over the globe. When the U.S. government was questioning if Honda automobiles had more than 50% U.S. contents, it became clear that General Motors, Ford, and Chrysler were not in a much better position. The issue of national origin is becoming an international trade problem.

Not only are capital, products, and services moving across borders with ease, but people are also moving around the globe at an increasing rate. Two factors related to corporate needs and human aspirations encourage immigration: (1) MNCs are promoting the best employees to higher positions and transferring them to places around the world where they can best serve the expanding, globally integrated firm (see Factor 7, page 7) and (2) educated, skilled, and cosmopolitan people in search of a better life find a relatively hospitable reception in many places where their skills and knowledge are needed. Of course, the issue of low-skill labor immigration is a separate matter. This movement exposes people, and particularly employees of MNCs, to diverse ways of thinking, behaving, and problem solving. This builds a closer relationship between MNCs, the host governments, and people from diverse cultures. People in host countries are exposed to cultural diversity and ethnic heterogeneity without traveling away from their homes. The end result is further globalization and an increase in the pace of the march toward a “global village.”

### **One More Step Toward the Global Village**

Bank of New York, along with Deutsche Bank, devised the structure of global shares to create an alternative for foreign companies to the American depository shares and receipts (ADSs and ADRs). Global shares are ordinary shares traded in multiple currencies around the world. ADSs and ADRs are not direct shareholdings. They are

derivatives of foreign shares created by a U.S. custodial bank. To sell them outside the U.S. banks, they must be converted back to ordinary shares. Their holders may lack the same voting privileges as ordinary shareholders. For these reasons, many foreign issuers consider global shares as an alternative.

In November 1998, DaimlerChrysler began trading as a global share in the United States, Germany, Japan, and five other countries. The financial services giant UBS and the German chemical company Celanese have followed DaimlerChrysler in issuing global shares.

The costs and complexities involved in global shares, however, have kept other potential issuers on the sideline. Linking the home country's clearing and settlement systems with those of the United States and harmonizing local regulations with those of the Securities and Exchange Commission are not simple tasks. We can claim to have arrived at the global village if and when we overcome these hurdles (adapted from Ref. 28).

## The Effect of the Internet

In addition to the nine factors already discussed, the development and widespread use of the Internet is a force that greatly influences internationalization of business activities. The advent of the Internet is akin to a revolution. It has permeated many aspects of our lives in ways no one could have anticipated. It has affected many business practices, transformed some, and created new ones.

The Internet reduces business entrance barriers and production costs and increases productivity. Above all, it greatly affects developing and expanding international business activities and presents a significant challenge to traditional internationalization arguments. Traditionally, companies would start small and be locally focused, growing gradually. The final stage of growth and expansion would take the firm to the international arena. With the use of the Internet, businesses can be designed from the beginning with the global market in mind. This type of organization is discussed in the chapter on organizational structure.

The Internet affects international business in the following ways:<sup>29,30</sup>

1. It increases global commonality in consumer needs and tastes. This, in turn, makes it possible for MNCs to use more global strategies (discussed in the chapter on strategy) through offering standardized products and services. This is possible because the appeal of globally recognized brands will increase as a result of the worldwide use of the Internet. At the same time, it creates more opportunities for less recognized products and companies in international markets. Dell

Computer, for example, by shifting its marketing and sales efforts to the Web, transformed itself from a contender to a leader in the personal computer industry.

2. It enables MNCs to centralize or coordinate their purchasing globally. In effect, it provides the opportunity to MNCs to become global customers. At the same time, it allows regional firms such as United Parcel Service and DHL to grow faster. Before the advent of the Internet and the Web, globally centralized purchasing required complex, expensive paper-based coordination of dispersed subsidiaries and suppliers. In the case of the Internet, more efficient global sourcing is possible.
3. It drives down global economies of scale, reducing the minimum efficient size of operation. Many physical activities are replaced by Web-based virtual activities. Also, the availability of global distribution channels allows companies to spend much less on international distribution systems or eliminates the need for such systems altogether. Therefore, as a result of reduced economies of scale and transaction costs, well-managed, smaller companies can effectively compete with larger MNCs. By substituting or supplementing physical activities, the Internet makes it easier for firms to participate at the global level. This feature has a couple of ramifications: (1) it allows for companies to be present in smaller markets, which were previously not economically feasible for them, and (2) it enables smaller companies to be global players. With the Internet, it is possible to have a global strategy and at the same time to be responsive to the particular needs of local markets.

### International Terrorism

Globalization has provided economic benefits to most nations. The vanishing effectiveness of national borders, increased international trade, the information explosion, including the use of the Internet, and increased immigration have also, however, made it easier for various groups to engage in terrorism. This adversely affects international business. But like the previous 10 factors, it increases the importance of international management. Business is always in search of lower risk and higher return on investment. Sociopolitical strife usually negatively influences business. An important component of strategic planning is the assessment of political risk, which deals with the negative consequences of sociopolitical instability and strife.<sup>31</sup> Because terrorism is a recent phenomenon, it has yet to be systematically incorporated into the business planning process. It is clear, however, that terrorism adversely affects national security.

The preceding 10 factors positively affect international business. International terrorism, however, negatively influences international business. It creates a unique form of nonbusiness risk. Nonbusiness risks are



commonly discussed under the topic of country risk or political risk. This topic has been explored by international scholars,<sup>32</sup> who maintain that it adversely affects FDI. The risk due to international terrorism is a recent issue. Its impact on business and the reaction to it are yet to receive scientific and scholarly scrutiny.

The issue of national security as it relates to more frequent acts of terrorism has become a very sensitive matter to industrialized countries. It has become very important particularly to the United States after the tragedy of September 11, 2001. Experts have been sounding alarms about securing the U.S. borders and particularly the ports.<sup>33</sup> The issue of port security drew a very strong uproar after the purchase of a British firm, which operated five terminals at U.S. ports, by Dubai Ports World (DPW). DPW is located in the United Arab Emirates, a country to the south of the Persian Gulf. Some argued that this event would create in the minds of international investors a country risk similar to those of politically volatile developing countries. Such a development could disrupt an increasingly interdependent world economy. It might discourage foreign investment in the United States, on which the nation is heavily dependent. An outcry against similar big acquisitions in Europe stirred concern over a rise in economic nationalism and a backlash against globalization.<sup>34</sup>

MNCs may be forced to react to terrorism against their assets and personnel by (1) forming armed security forces to protect their interests in foreign countries;<sup>35</sup> (2) increasing advance training<sup>36</sup> and proper employee selection for foreign assignments (see the chapter on international human resources); and (3) following experts' recommendations to the intelligence community<sup>37</sup> to improve and expand international management education and training for those assigned to foreign operations.

## The Imperatives of the Globalization of Business

In this section, we will discuss the imperatives of globalization of business. First, we will elaborate the need for going international. Then, we will present theories of international trade and FDI. Finally, within the framework of product life cycle, we will explain the firm's expansion into international markets.

### Why Do Businesses Expand Their Operations Abroad?

International competition affects most businesses and results in the globalization of many industries. The unprecedented information explosion has greatly contributed to international competition. Technological developments have also reduced transportation costs. Consequently, the physical distance between producers and consumers is no longer much of a competitive

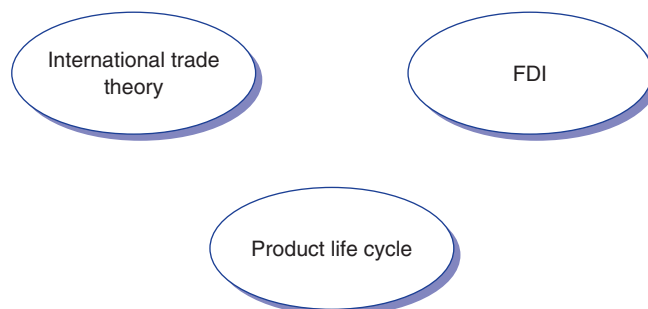
hindrance. Domestic firms with unique products or services, or with a competitive advantage, can expand beyond their home market easily.

In today's environment, going international is either an extension of successful domestic business operations or a requirement for remaining competitive. Increased worldwide interdependencies, if continued at the present pace, would make internationalization a requisite for survival. Until that time, many organizations operate at national and international levels as if these two were totally independent. Given this crude assumption, scholars argue on the motives and reasons for firms going international.

Three major theories—international trade, FDI, and product life cycle—have attempted to explain the reasons and motives for international expansion (see Figure 1.2). These theories provide the following explanations.

### *Theories of International Trade*

International trade theorists propose that nations gain from international trade (exports and imports). The gains are the consequences of exploiting relative comparative advantage. **Comparative advantage** is derived from exporting those goods for which a nation holds a superior position in regard to production costs. This superiority could stem from natural resource endowments, such as climate, quality of land, or differences in the cost of labor, capital, technology, and entrepreneurship. Opportunity cost plays an important role in comparative advantage. To produce one product, a country has to give up production of another, and this entails an opportunity cost. Nations benefit from international trade when they export products that they specialize in, because they have the greatest comparative advantage, and import those products in which they have the greatest comparative disadvantage. Free trade does not require that one country gain at another country's expense. Free trade is a win-win deal (p. 266).<sup>8</sup>



**Figure 1.2** Major Theories of the Firm's International Expansion

### *Foreign Direct Investment Theory*

Theories of FDI suggest that four factors influence MNCs' expansion abroad:

1. A change in geographical horizons<sup>38</sup>
2. The possession of an ownership-specific advantage<sup>39</sup>
3. The exploitation of the firm's internal market<sup>40</sup>
4. The effect of locational advantages of host countries

*A Change in Geographical Horizons.* As firms grow and expand abroad, under the influence of external and internal forces, their geographical horizons widen. The changes in their horizons let them notice international opportunities and stimulate them to invest and expand internationally.

*Ownership-Specific Advantage.* Compared with local firms, MNCs face certain disadvantages. These disadvantages are the lack of knowledge about the economic, political, legal, and social situations of foreign countries. Geographical distance, currency exchange risk, and language barriers create further difficulties. The established relationships between domestic firms and their suppliers, customers, and regulatory agencies put MNCs at additional disadvantage. When a firm acquires a global horizon and goes international, it can benefit from investments in foreign countries if it has an ownership-specific advantage to offset the disadvantage of its foreignness. The ownership-specific advantage, which is also called strategic advantage, could be a patented technology, product differentiation, economies of scale, brand names, managerial skills, or possession of knowledge.

*To Exploit the Firm's Internal Market.* A firm's strategic advantage could be licensed, franchised, or traded to local firms. Therefore, ownership-specific advantage alone is not sufficient for a firm to go international. An *internal market* should allow for more effective use of strategic advantages than would contractual agreements with other firms. *Internal market* refers to organizational capabilities, scattered throughout the firm, that could employ the firm's strategic advantages better than would outside business partners. Specifically, the firm's internal market can best exploit the strategic advantages in the firm's intermediate products. Some of these strategic advantages, such as knowledge and expertise, which may ultimately result in a patent, could best be capitalized using the firm's internal market. Unless such knowledge and expertise culminate in products, there is no ready market for them in their intermediate states. The creation of an internal market through international expansion ensures full exploitation of these strategic advantages.

*Locational Advantage.* Building organizational capabilities and the use of strategic advantages through international expansion do not determine the location of foreign investment. MNCs must justify the choice of investment location. In which foreign countries should MNCs expand? The answer is very simple. MNCs should locate their operations in countries that offer certain locational advantages, such as sources of raw materials, large markets, or low-cost labor.

In summary, four factors determine international expansion: an awareness of international opportunities, the firm's strategic advantage, the rationalization of strategic advantage through an internal market, and the foreign country's locational advantage.

*Other Factors.* Once a firm, for whatever reason, expands abroad, there is the likelihood that it will develop scanning and learning capabilities. Its presence in many markets enables the firm to locate alternative low-cost production sources and new technologies or learn about market needs that could trigger new product development.<sup>41</sup> In effect, scanning and learning capabilities enhance the firm's competitive advantage. The worldwide presence could also be used as a competitive weapon and for cross-subsidization of markets. Taking the competition head-on, by penetrating into their home turf, forces foreign competition to allocate resources for defensive purposes. Subsidizing losses in one market with funds from another profitable market could hamper the competitive position of rivals.<sup>42</sup> The penetration of rivals' home markets and cross-subsidization could adversely affect the competition. Competition may suffer from significant cash drain, reduced income, and lost opportunities. This could impair the competitors' ability to expand into new markets.

### *Revised International Product Life Cycle*

International product life cycle, first proposed by Raymond Vernon,<sup>43</sup> and expanded on by Adler and Ghadar,<sup>44</sup> suggests a sequential progress for the firm's expansion into the international market, which follows the life cycle of products. Vernon proposed a three-stage model of product life cycle, which was useful in explaining the expansion of post-World War II manufacturing investment abroad. But recent changes in the international environment have reduced the model's appeal. Adler and Ghadar's addition of a fourth stage, which accounts for recent international environmental changes, has improved the model.

The three stages proposed by Vernon are new product stage, mature product stage, and standardized product stage. The model suggests that high-income, economically developed countries are the home for most new products and innovations.

*Stage 1: New product:* In the first stage, innovating firms in developed countries produce new products for the home market. These products are manufactured at home. Foreign markets, which are other high-income

countries, are served through exports. At this stage, since products are new, the firms do not face serious competition.

*Stage 2: Mature product:* The maturity phase is the second stage, where products have been perfected and sufficiently standardized. As more firms enter the market, price competition forces them to establish manufacturing facilities in other high-income countries, to serve foreign markets with local production. Recent technological developments in industrializing countries are forcing firms to bypass this stage and directly move to the next stage.

*Stage 3: Standard product:* Heavy price competition characterizes the standardized product stage. The emphasis on price compels firms to move production to low-cost countries. The home market and other high-income countries are served by exports from these locations.

The three-stage international product life cycle is a useful model that explains internationalization of firms for the 20-year period following World War II. Technological developments, however, have accelerated the life cycle of products, where most products become obsolete much faster. Furthermore, the world has become an integrated market that requires mass customization of products to meet individual needs. This brings us to the fourth stage.

*Stage 4: International product:* According to Adler and Ghadar, we are in the fourth stage of the international product life cycle. This stage is characterized by technological diffusion, high costs of research and development, a global market, mass customization of products, and intense competition among firms from developed and newly developing countries.

In the first three stages, internationalization was in response to specific needs, such as market extension or low-cost production. Adler and Ghadar's argument implies that in the fourth stage, firms go international because the line between domestic and foreign markets, for many manufactured products, is blurring. By the fourth stage, the global market is the source of new technology, capital, and other factors of production at low costs. Internationalization is not an extension of the previous stages but a stage unto itself. It is the diversity and resources of the global market, the immense consumer base, and the necessity of tapping them that instigate FDI and international trade. Due to the unique characteristics of this stage, global operation is the only answer to the pressure of intense competition. As Adler and Ghadar<sup>44</sup> assert,

[In the fourth stage,] . . . top-quality, least-possible-cost products and services become the minimally acceptable standard. Competitive advantage comes from sophisticated global strategies based on mass customization. Firms draw product ideas, as well as the factors and locations of production, from worldwide sources. Firms tailor final products and their relationship to clients to very discrete market

niches . . . [T]he product, market, and price orientations of prior phases almost completely disappear, having been replaced by a strategic orientation combining responsive design and delivery with quick, least-possible-cost production . . . {At this stage} strategic orientation requires firms to develop global R&D, production, and marketing networks. (p. 189)

The preceding discussion highlighted various reasons and motivations for the internationalization of the firm. We should add, however, that rarely is the decision to expand abroad based on a solitary reason or motive. The search for enhancing their competitive position entices firms to explore global opportunities. The more adaptable and successful firms usually dare venturing into uncharted waters of the global market. Once there, through first-hand experience, they learn about the expanse of the market and the variety of choices. The wide range of opportunities creates many more reasons to expand further.

## Types of International Business Operations

The internationalization process covers a variety of transactions and activities. Imports and exports are two of the simplest forms of international business. The most complex form is managing FDI abroad. These activities can be differentiated based on the perspective of the activities or the types of investment commitment (pp. 3–6).<sup>45</sup>

### Perspectives on International Business Activities

International business activities can be viewed from two different perspectives: (1) inward looking and (2) outward looking. These two perspectives are the mirror images of each other.

*Inward looking:* The inward-looking perspective covers a range of transactions that starts from a foreign location and ends up at home. It consists of imports at one end and the management of a wholly owned foreign subsidiary at the other end.

*Outward looking:* The outward-looking activities have their beginning at home and their ending at a foreign market. Export is the least demanding of the outward-looking transactions, while establishing operational facilities in a foreign country is the most difficult one.

As mentioned above, the firm's internationalization process begins when it starts to buy from or sell to foreigners. The most serious aspect of the process, however, does not start till the firm commits resources to international

activities. The type of foreign investment commitment that a firm may make to international business could be analyzed across three dimensions (see Figure 1.3):

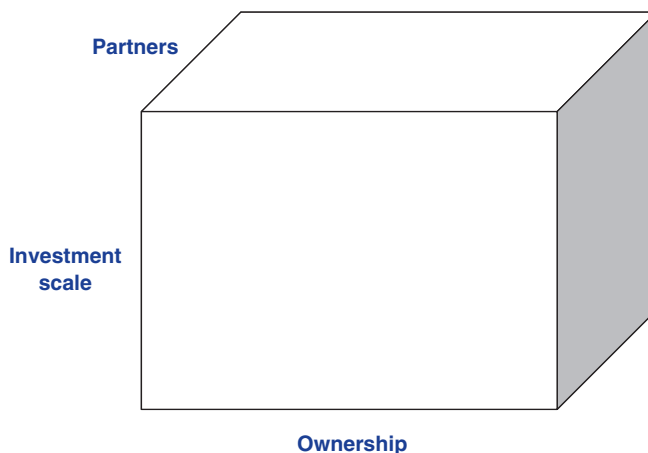
1. Scale of investment
2. Ownership arrangement
3. Type of partners

Investment scale could be small or large. An example of small investment is that of opening a sales office abroad for exporting. Establishing a full-scale production facility abroad is an example of a large-scale investment. The ownership level could vary from minority ownership to wholly owned operations. Partners in an international business could be from local public, local government, or private entities or from other foreign firms.<sup>44</sup> MNCs may choose a combination of these alternatives in their quest to capitalize on the global opportunities available to them.

### *Direct Investment*

There are various options for business expansion beyond the home country market. When a firm explores whether to expand abroad, the first choice and the simplest is export and its mirror image, import. The most demanding and complex form of international business operation is direct investment in the host country, which is called FDI.

FDI involves the ownership and management of physical facilities for producing goods in foreign countries. FDI could be a part of the overall strategy of the firm, or it may be due to trade restrictions imposed by foreign governments. To overcome these restrictions, MNCs find it advantageous



**Figure 1.3** Dimensions of International Business Involvement

to invest directly in a country and establish a subsidiary. When a firm establishes production operations abroad, it creates a long-term commitment and obligation and assumes the associated risks and rewards. Having physical facilities such as mining operations, manufacturing plants and equipment, and real estates requires a higher level of financial and human resources commitment. The firm must contend with foreign governments, their policy changes, and local market forces to reap the benefits of operating internationally.

The size and scope of FDI and the choice of strategies for expansion abroad create different types of international firms. These firms may be referred to as international, multidomestic, multinational, transnational, and global. Different scholars have used each term to refer to a specific type of international firm. In this book, we generally use the term *international* for all firms that expand abroad and cross the boundaries of their domestic market. For “industry” identification, however, we distinguish between multidomestic, international, and global industries. We will discuss the differences among them in the chapter on international strategic planning. At this point, it is enough to know that global firms are those enterprises that operate at the global level and treat the whole world as one market.

## International Business and International Management

*International business* deals with business activities and transactions that are carried out across two or more national borders. The management of organizations that are involved in international business is called *international management*. A couple of decades ago, only large and very resourceful firms could operate successfully at the international level. While many international businesses still involve large-scale operations, recent improvements in technology, transportation, and communications and the advent of the Internet have made the size of operations less relevant.

Small companies are using new technologies to penetrate markets that previously were the domain of big business. The success of small firms is not limited to any particular industry or market. Semiconductors, medical equipment, laundry equipment, and wastewater treatment systems are among the many industries that have entered the global market as small businesses. For example, Sharper Finish, Inc., of Chicago, a maker of commercial laundry equipment, deals with 300 distributors in 30 countries, using modern communication technologies. Another example is Midwest Tropical, Inc., of Chicago. Tropical is earning half its revenues from export.<sup>46</sup> A third example is DSP Group, Inc., of San Jose, California, a producer of specialty semiconductors. Nearly half of DSP's sales are to Japan. Although they are from diverse industries, these firms have in common an understanding that managing an international business operation is different from managing a



domestic firm. They are all effective in adapting to the requirements of their foreign customers and the requirements of the host country.<sup>47</sup> This newer form of organization, which from its inception caters to the world market, is discussed in the chapter on the organizational structure of an MNC.

Most of the U.S. management know-how, as Richman and Copen<sup>48</sup> observed more than three decades ago, if modified properly, is transferable to other environments (p. 5). The assumption of universality of management concepts and practices, however, could result in utter failure in international business. In other words, there are as many differences as there are similarities between the management of an international enterprise and a domestic business. The differences have less to do with the size of the assets, the earnings, the complexity of the technology employed, or the number of employees. Although all these factors play a role in the success of an enterprise, the differences are primarily due to environmental factors and cultural variations. International management involves greater environmental diversity, complexity, and uncertainty than managing domestic operations. Social, political, legal, economic, and cultural variations of multiple environments require more careful planning and preparation and also a greater diligence in implementation and control.

When a firm ventures abroad into international business, it leaves behind familiar and tested business practices. Everything about the forces that govern the market has to be learned anew. The consumers, competition, suppliers, government, labor market, capital market, and, above all, culture are unfamiliar. While a domestic firm has to deal with only one set of rules regarding market forces, an international operation requires understanding of the interaction between all these forces in multiple markets. International business, especially doing business with developing countries, may offer attractive market opportunities and significant profits, but it also presents many unexpected challenges. Those working in the developing markets may have to deal with disease, civil unrest, difficult living conditions, impossible bureaucracies,<sup>49</sup> and terrorism.<sup>50,51,52</sup>

Although going international may appear fraught with many problems and difficulties, at the same time, it offers many opportunities not available in a purely domestic operation. For example, one of the complexities of international business is doing business in multiple currencies. Exchange rates for foreign currencies fluctuate due to local and global economic forces. Two major forces affect the exchange rate: (1) supply and demand for a foreign currency and (2) domestic conditions, such as the inflation rate, balance of payments, economic growth, and political factors. Exchange rate fluctuation can create additional risk, while at the same time it may offer opportunities. MNCs could use their unique position of operating across national borders to benefit from favorable exchange rates. They could add to the benefits of favorable exchange rates with intrafirm business transactions to boost their profits. Research on firms' performance indicates that internationalization increases financial returns. Firms can extend the product life cycle by shifting sales of outdated products in industrialized countries to

developing countries. Also, by operating in many countries, firms can reduce their exposure to environmental risks and increase their bargaining power with their host countries.<sup>29</sup>

In the following pages, we will examine the outstanding features of managing international business operations that distinguish them from domestic businesses.

## Major Elements of Managing International Business Operations

The management of international business is very similar to, and very different from, the management of domestic business. The management of international business and that of domestic operations are similar in that both require the attainment of organizational objectives through coordination of activities and utilization of resources. They are different because of the differences in their respective environments and cultural settings. These differences increase the costs and the risks of operating far-flung foreign operations.<sup>53</sup>

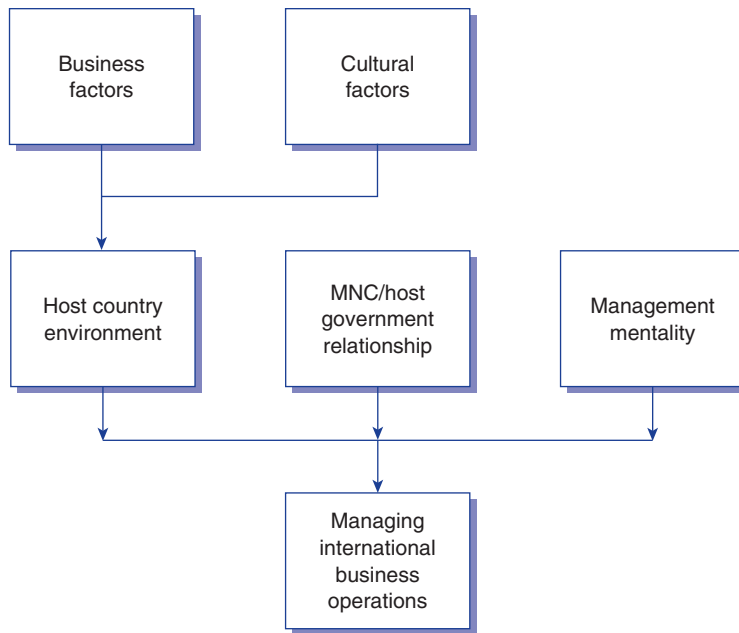
The difference is also due to managerial attitudes and mentality. International business has a multi-environment, multicultural framework. The cultural and environmental diversity adds more complexity and uncertainty to international business. This makes the management of such an operation more difficult. Three factors make the management of international business difficult (see Figure 1.4):

1. Management view of international business
2. Host country environment
3. MNCs and host government relationships

The difficulty of managing an international business operation is also due to a mismatch between the managerial mentality and the progression of business from a domestic to an international position. When expanding from a domestic position to an international status is not accompanied by a commensurate change in managerial mentality, the firm may not succeed in international competition. For example, a firm that has expanded to many markets and is dealing with the people from many cultures no longer can operate with the mentality of a domestic company. Ignoring the expanded role of the firm as a corporate citizen of multiple countries results in a tarnished image and operational restrictions. The consequences may ultimately be failure.

### Management View of International Business

In the past, some scholars have suggested that the truly international firms could offer the best hope for creating world peace and improving the



**Figure 1.4** Major Elements of Managing International Business Operations

economic conditions of the people. They were asserting that such firms, with supranational frameworks, could conceivably make wars less likely, on the assumption that bombing customers, suppliers, and employees is in nobody's interest.<sup>54</sup> We are now witnessing the emergence of such supranational firms that could rightly be called global. The executives of these firms have a global view and mentality. They focus on worldwide objectives, as well as local objectives. They are globally integrated and locally responsive. The relationship between headquarters and subsidiaries is based on mutual understanding and support. Subsidiaries are neither satellites nor totally independent. They always ask the question, "Where in the world shall we raise money, build our plant, conduct R&D, get and launch new ideas to serve our present and future customers?" (p. 13).<sup>54</sup> Globalization is rendering the traditional way of doing business, and along with it, the parochial mentality, irrelevant. To be globally competitive, managers need to develop a global perspective.<sup>55</sup>

Of course, not all the firms that are engaged in international business have developed a supranational framework and mentality. There appears to be an evolutionary pattern of internationalization that determines executives' state of mind. This state of mind has to do with the attitude of the executives toward foreign people, ideas, and resources, at home and abroad. This attitude differentiates not only between the executives of international and domestic firms but also among executives of MNCs.

Perlmutter proposed that the degree of internationalization of a firm could be estimated by the mentality and orientation of its executives.<sup>54</sup> He identified three states of mind or attitudes toward key decisions on products, functions, and geography. By supplementing the three-stage framework identified by Perlmutter<sup>54</sup> with ideas presented by others (Refs. 56, pp. 71–86; 57, pp. 11–14), the evolutionary process of multinational firms and their executives' mentality could be categorized in four stages. The four stages are *ethnocentric* (or home country mentality), *polycentric* (or host country mentality), *centocentric* (or classical global mentality), and *geocentric* (or supranational mentality). They represent the managerial mentality and attitudes of MNCs.

### *Ethnocentric Mentality*

The ethnocentric firm views foreign markets as an extension of the domestic market. It treats everything from the home country as superior and everything foreign as inferior. Products are produced for the home market and are exported abroad as an additional source of revenue. The firm headquarters and affiliates are identified by the nationality of the home country. Key managerial positions, both at the headquarters and at the subsidiaries, are reserved for home country executives. A foreign assignment is not considered a very desirable appointment and does not advance the professional career of a manager. In short, an ethnocentric firm views itself as a domestic firm with foreign extensions.

### *Polycentric Mentality*

In a polycentric firm, the prevailing attitude is that foreigners are different and difficult to understand. The assumption, therefore, is that the management of foreign affiliates should be left to local people. Products are produced for local consumption in facilities that are operated by host country personnel. Headquarters' control is exercised through financial reports. The firm could best be characterized as a confederation of loosely connected, semiautonomous affiliates.

Although on the surface it may appear that a polycentric firm operating in multiple markets and acting as a local company in every market is a highly internationalized enterprise, this is far from the truth. In a polycentric firm, local managers are not treated as equals to home country managers and are considered somewhat less trustworthy and competent. They cannot aspire to a high-level executive position at the headquarters. Consequently, local managers, who detect headquarters' ignorance of local conditions in its management of subsidiaries and resent the treatment they are receiving, are pulled into a virulent ethnocentric mentality.

### *Centocentric Mentality*

The local responsiveness of polycentric firms results in inefficient operations. Attention to local markets and the demands of local governments creates a system within each subsidiary that ignores internal market opportunities. Manufacturing facilities are often underutilized, and the full benefits of economies of scale are not realized.

Decreasing trade barriers and improvements in telecommunication technologies and transportation allow the use of classical global strategies, viewing the world as one market. We label such an attitude centocentric. Treating the world as one market enables the firm to take advantage of economies of scale in the design, manufacturing, and marketing of products and in research and development. Quite often, products are designed and manufactured at home for the world market. A centocentric firm assumes that nations are more similar in tastes and preferences than they are different. The assumption is that the differences could be made inconsequential by providing better-quality products at lower prices compared with domestic products. Therefore, uniform products could be produced at centers for distribution to all. Centocentric firms require more central control than others. Headquarters maintains control by assigning products or business managers with global responsibilities. The firm is still identified with the home country, and business managers are home country nationals, as are other key executives. The home country culture and the culture of the headquarters permeate the firm and all the subsidiaries. Only local managers who identify with the dominant culture of the headquarters are promoted to key positions. Important strategic decisions are made at the headquarters, and subsidiaries are expected to implement them.

### *Geocentric Mentality*

The success of centocentric MNCs and the power they exert on the local market cause resentment and apprehension. Central control over subsidiaries that dictates major decisions from the home office and identification with the home country produce additional concerns. To offset the perceived power and control exerted by global firms on the local market, host governments are restricting their operations. They also pressure MNCs for more local investment and technology transfer by enacting local content laws. Some governments demand changes in MNCs' personnel policies to allow for local representation in managerial ranks. Moreover, the global market is proving to be more heterogeneous than centocentric MNCs had assumed. The volatility of the global economic and political environment is another reason for global firms to become locally responsive. Add to all this the improvements in manufacturing technologies that have enabled more efficient flexible manufacturing and smaller batch production, and the stage is set for localized strategies.

There are two simultaneous demands on global firms. On the one hand, they are expected to be locally responsive. On the other hand, maintaining worldwide competitiveness requires a higher degree of efficiency, which is possible only with a globally integrated operation. This gives rise to emerging geocentric firms. Geocentric firms view themselves as global companies with no geographic center, in which no nationalities dominate. Viewing the world as their home, geocentric firms strive for flexibility and efficiency globally. Successful geocentric firms think globally and act locally. They integrate an interdependent network of decentralized and specialized companies worldwide. Perhaps the best way to describe a geocentric firm is to look at the operation of one. An example of a geocentric firm is Asea Brown Boveri (ABB), a global electrical systems equipment company.<sup>58</sup> ABB started as a Swedish firm that later merged with a Swiss company and made Zurich its headquarters. The chief executive officer (CEO) of the company described ABB as follows:<sup>59</sup>

ABB is a company with no geographic center, no national ax to grind. We are a federation of national companies with a global coordination center. Are we a Swiss company? Our headquarters is in Zurich, but only 100 professionals work at headquarters and we will not increase that number. Are we a Swedish company? I'm the CEO, and I was born in Sweden, and only two of the eight members of our board of directors are Swedes. Perhaps we are an American company. We report our financial results in U.S. dollars, and English is ABB's official language. We conduct all high-level meetings in English.

My point is that ABB is none of those things—and all of those things. We are not homeless. We are a company with many homes. (p. 92)

### MNCs and Host Government Relationships

The relationship between business and government has always been an area of considerable concern. Governments in their quest for economic development and social programs enact regulations that may restrict business activities or affect earnings. Often, government economic policies and social agendas do not coincide with the goals and objectives of business. Particularly, governments are skeptical of foreign subsidiaries, which are controlled by headquarters outside the country. Influencing the strategies of such foreign affiliates is not as easy as influencing those of domestic firms. Governments can, nonetheless, affect the local subsidiaries of MNCs through their public policy decisions. In dealing with MNCs, the sovereign power of a government renders objections from MNCs mute. This is not to say that governments always have an upper hand in their dealings with MNCs. Usually, the ability of integrated MNCs to acquire capital, material, technology, and labor globally reduces the effectiveness of most government policies.

### Global Regulator?

The recent dynamism of global finance has been attributed to fewer regulations on the movement of capital across borders. Capital has been free to move where it could produce the highest return. As a result, most countries have improved their regulations to attract mobile capital. This has produced the convergence of regulations around common international standards. But certain problems remain. National regulatory agencies are no match for global financial firms such as General Electric Capital, the Citigroup, or Deutsche Bank, which operate at the global level. Also, there are too many national and local regulators, particularly in the United States, with no agreement among them. The idea of a single global regulator is on no one's agenda. What the regulators want is the guarantee that good information is available about the state of global markets and about financial firms' global operations.

The three multinational institutions, the International Monetary Fund, the Bank for International Settlements, and the Financial Stability Forum, play an important role in advancing the idea of a single global regulator. But there is no consensus on what should be regulated. Until now, America's awkward regulatory system does not seem to have delayed the development of its markets, but in the long run, it may prove costly if the EU succeeds in fully integrating its capital markets and introducing appropriate regulation. In fact, it is possible that pressure from the EU will help make the U.S. regulations uniform and advance the idea of a global consensus on the issue (adapted from Ref. 60).

Host governments would like foreign firms to invest in the country, create jobs, facilitate technology transfer, and help with balance of payment through exports. Foreign firms with limited operations abroad are forced to comply with government policies more readily. Their subsidiaries can comply more easily because they do not face the conflicting demands of multiple governments. But integrated MNCs, due to the nature of their operations, may not be able to respond favorably to host government demands. The demands of one government may differ from the requirements of another.

For example, many developing countries, to earn hard currency, are emphasizing exports. To give in to the pressure by one government to increase exports is to jeopardize the relationship with others. Moreover, the flexibility of a globally integrated operation enables these MNCs to withstand the demands of local governments by capitalizing on their internal market. Globally integrated MNCs could supplement the operational

restrictions imposed on them in one country with increased business in the other countries.

The foregoing argument may give an exaggerated impression of the power and flexibility of globally integrated firms. Host government relationships with MNCs are very complex and do not lend themselves to simple generalizations. For instance, it is true that reallocation of resources among subsidiaries, shifting of production between various locations, and the use of the firm's internal market are very effective tools for foiling unfavorable policies of the host government. If a host government applies serious pressure on the MNC to severely hamper its business, the MNC's choices are not many. The size of investment and the commitment of the MNC to a host country reduce its flexibility. FDI in plants, production equipment, and physical facilities that are not readily mobile reduces the flexibility of integrated strategies, at least in the short run. In the short run, accommodating the host government may be a wise choice.

Host government subsidies to domestic firms, or the use of the government's purchasing power to give preference to domestic firms, could create unfavorable business conditions for MNCs. Changes in tax laws and labor laws, repatriation of profits, and a host of other regulations and restrictions are sources of additional risk. Political risk increases the cost of doing business abroad and makes FDI a challenging and demanding proposition. Foreign governments have had a history of such practices. The political risk of operating in a foreign country is a reality that MNCs have to deal with. A sudden and dramatic change in government policy toward FDI, though less frequent in recent years, is a distinct possibility that MNCs have to consider when going abroad.

The most troublesome feature of managing across national borders is dealing with the public policies of the home government that are in conflict with host government policies. Complying with the policies of either government could create legal problems for the executives. Consider the quandary of Caterpillar executives during the construction of the Soviet pipeline to Western Europe in the early 1980s. The U.S. government, to punish the Soviet Union for its expansionist policies, ordered Caterpillar to stop selling earthmoving equipment to the Soviet Union. Caterpillar executives complied and stopped shipping equipment from the Peoria, Illinois, plant. The French subsidiary of Caterpillar, however, under the order of the French government, continued delivery of equipment to the Soviets. Caterpillar executives, though following U.S. policies, were not able to satisfy the mandate of the U.S. government.

### **Host Country Business Environment**

Besides the complexity of relationships with the host government, MNCs have to deal with the local workforce, domestic and international



competition, and local suppliers and customers, which are different from those in the home country. Cultural differences are a major source of difficulty in managing a global firm. Faced with multiple cultures, MNCs have to adjust and adopt their managerial practices to accommodate the differences among various cultures. Fluctuations in the exchange rate create an additional burden for MNCs. These issues will be discussed in other chapters.

In short, managing an MNC is not managing a larger domestic firm. It involves a change in management mentality and greater attention to the requirements of doing business. The different requirements for managing global firms are a result of the multiple environments of foreign countries and the additional complexity of operating across national borders.

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## Summary

This chapter explained why international business and management are important to us and why we should learn about them. It was suggested that the prolonged peace after World War II has changed the nature of international rivalry. The diminishing threat of large-scale military conflict between the superpowers has shifted the emphasis from military supremacy to economic competition. The changing attitudes of nations toward global relationships facilitate increased international business. Therefore, understanding the concepts and theories of international business and management has gained added importance.

To learn about international management, the question of why businesses go international was examined. Included in the examination were theories of international trade, FDI, and international product life cycle.

International business operations cover a spectrum of activities, ranging from exporting to direct investment. Various types of international business operations were described. It was proposed that management of these varied business operations is not the same as that of domestic business. The differences between international management and management of domestic business are due to the complexity of the international environment. Internationalization of the firm involves not only the expansion of the operations abroad but also a change in management mentality. The management view of international business is categorized into four stages: ethnocentric, polycentric, centocentric, and geocentric.

The business-host government relationship is a major source of difficulty for MNCs. The flexibility and resourcefulness of integrated global firms, when paired with the sovereign power of host governments, create a challenging and demanding proposition for management. Other factors that make international management different from managing domestic operations are cultural differences and currency exchange fluctuations. These issues will be covered in other chapters.

## Discussion Questions

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1. Why is it important to learn about international management?
2. What factors contribute to the increased role of international business in our lives?
3. Explain the reasons for firms' international expansion.
4. Raymond Vernon proposed a three-stage international product life cycle. Describe these stages. Adler and Ghadar suggested the addition of a fourth stage. What are the characteristics of the fourth stage?
5. What is the difference between the inward-looking and outward-looking perspectives of international business?
6. How many different types of international business operations can you identify? Describe in detail a major international business operation.
7. Describe international management.
8. In what ways are international management and the management of domestic operations similar? What are their differences?
9. The author asserts that a major differentiating factor among executives of domestic businesses and those of MNCs is managerial mentality (their view of business). This attitude also differentiates among MNC executives. Explain the four stages of managerial mentality.
10. Why do host governments have less influence on integrated global firms?
11. The relationships between the host government and MNCs is more complex than government-domestic business relations. Why?
12. What aspects of international business are affected by the Internet?
13. Review the vignette of this chapter more carefully, and explain the problems of the global wine industry. Use library resources and other material to elaborate on these problems. Explain how international business is transforming the industry and forcing it to consolidate.

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